

Good MornING Asia - 20 June 2019

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Fed meeting - a case of the dog that didn't bark

The latest FOMC meeting dot median for 2019 did not fall, and the projections as a whole for 2019 and 2020 did not fall by as much as expected. A July rate cut is still a possibility, but the Fed isn't screaming out that it is a probability. 50bp starter cuts don't look likely. But the bond market has rallied anyway, with a 25bp July cut more than fully priced in.



Source: Shutterstock
Fed Chair, Jerome Powell

Fed under-delivers relative to the market, but the market still rallies

There was a lot of unrealistic anticipation before this Fed meeting, mainly in terms of it laying the foundations for some aggressive easing in the months to come. As our US economist, [James Knightley put it so well](#), there was a decent change in the Fed's language last night, dropping the "cautious" text in favour of "closely monitoring", but the forecasts, in terms of the dot plot median for 2019 did not even shift down at this meeting, though they are on the cusp of doing so. On top of which, there is only one cut projected for 2020.

Contrast this with the market, which now has one 25bp cut fully priced in for July, and a further cut

at that meeting 24% priced in. The Fed funds futures implied rates suggest the effective Fed funds rate will decline to 1.665% by the December meeting (it is 2.37% today, implying a fall of more than 70bp - so nearly 3 full rate hikes by the end of the year). And it predicts the trough of rates coming at 1.29%, so practically 100bp of easing from today.

To me, that looks a lot too much, and even if the Fed's path is now towards easing, I think it is going to be a lot slower than these market implied rates suggest.

50bp starter cut - the arguments for and against

A growing market call is for the first Fed easing to come in at 50bp, not 25bp. That would explain the July pricing. There is some historical support for this, but usually only at the beginning of an oncoming crisis. A good article on Bloomberg yesterday talked about how Former Fed Chairman, Alan Greenspan, justified this approach, arguing that at the point you realized it was time for a cut, then you also realized that your last hike was one too many, requiring any move towards accommodation to cut not just once, but twice, to remove the excess tightening from the previous meeting.

That would make more sense if the Fed was hiking every meeting at 25bp as Greenspan used to do, not maintaining its cautious stance for more than six months. It might make more sense too if the Fed funds peak were not just 2.5%, rather than 4.5% or higher as it was at the last peak. It might make more sense if the economic data was screaming out a need for easing in the face of an oncoming recession. But while the data has been, in the Fed's own words, "moderate", there are still some decent pockets of strength, and the weaknesses don't look too threatening just yet.

The wild card to all of this is, of course, the Trade War and the US president. But I can't predict that or him, irrespective of base cases that we use to anchor our forecasts. I don't think the market can predict this either. So to put it bluntly, relative to current conditions, the market has priced in way too much easing way too quickly, and at some point, something has to give.

Market response puzzling

Markets this morning are scrambling to make the Fed no-change decision yesterday and accompanying guidance a dovish story. It is, but not relative to their expectations. 10Y yields are down nearly 7-8bp from their pre-FOMC position. 2-year yields are down even more, falling from almost 1.88% to 1.73%. There is virtually no justification for that in the face of last night's information. Indeed, it would have been less surprising to see a front end sell-off, though the back-end response was always going to be tempered by the equity market reaction.

For now, equities seem to be running with the notion that this is all a good news story. The S&P500 is up, though not a lot, and maybe it is showing understandable signs of confusion that last night's meeting was maybe not the good news story the bond market seems to think it was.

FX markets are taking their cues from the front end of the US Treasury curve, with EURUSD now up to 1.1235 as of writing. Gold rallied briefly as high as \$1362/oz, but has dropped back now, and front-month WTI oil futures are up a bit as well - possibly a USD response, though there is a lot of inventory noise to muddy this particular market.

All of these, with the possible exception of oil, look as if they are overdone given the underlying driver of rate cut expectations. A catalyst is needed though to cause a re-think. Maybe a bounce

back from last month's payrolls disappointment would do it. Recent Canadian inflation figures are also perhaps a reminder that low inflation may indeed be transitory, as the Fed has been claiming. But we will have to wait quite a few weeks for data on either to upturn the current market view.

EU meets for a chat, and probably a nice lunch

The next few days will show us the way to the next ECB President. EU leaders will be pushing their respective candidates for a variety of posts, notably, the Head of the EU Commission, the President of the EU Council, and the one that matters most for financial markets, the President of the ECB.

Deliberations are supposed to end by Friday lunchtime, though this may be optimistic. If not, then by the weekend, the EU Commission and EU Council jobs should be stitched up, and we will have a far better idea who will be replacing Mario Draghi at the ECB in the autumn.

[One way to view this is, which job will Germany get?](#) Chancellor Merkel wants her man, Manfred Weber to get the Commission. But France's Macron doesn't, and his compromise candidate of Margrethe Vestager (of Denmark) might then get the nod. If so, Jens Weidmann (Germany) could well be in with a very good chance of getting the ECB presidency, and that could make things interesting, as he is about the most hawkish candidate there is for the job - though, in all fairness, he has recently softened his tone, perhaps in preparation for the job.

The anticipation of a Weidmann Presidency could add to EUR strength in the coming months.

Asia - Central Bank "Super Thursday"

It's a big day for central banks today, but we may well come away from all this with no easing, like the Fed. The central banks of the Philippines and Indonesia both meet to decide policy. Both have talked a good game about possible easing, subject to the data and in BI's case, subject to the state of the current account and IDR. We are predicting an "open door" to easing from both, without either of them actually cutting rates. However, if either bank does cut, my money is on the BSP, where the external balance has been looking pretty good, with a surplus registered each month since November last year.

Taiwan's central bank also meets today, as does the Bank of Japan. Similar issues exist for both but are more extreme for the BoJ. Weak growth and low inflation face already low (Taiwan) or negative (Japan) interest rates. Some further easing from Taiwan's central bank is possible, though they seem very reluctant to move below the current 1.375% benchmark interest rate. As for the BoJ, Governor Kuroda is talking a brave game of forward guidance, monetary base expansion, outright asset purchases and more negative rates. But he must know that the BoJ's ammunition is painfully low and exceptionally weak, and he will not want to throw it away unnecessarily. Only when the JPY is a lot lower, do I think they will really consider unleashing anything other than words. And words won't do anything.

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ASEAN Morning Bytes

General market tone: Slight risk-on. Markets remain on edge as Fed sticks to the dovish script while regional central banks meeting on Thursday.



EM Space: With the Fed dot plots shifting, markets await Asian central banks's response

- **General Asia:** Asian central banks get busy with four of them (in Japan, Taiwan, Indonesia, and the Philippines) meeting today and are likely following the US Fed with dovish policy guidance if not outright policy rate cuts. As such, the overnight risk-on sentiment in the US market is expected to be carried over in the Asian session today.
- **Malaysia:** Bank Negara Malaysia's Governor Nor Shamsiah Mohd Yunus is hopeful of possible trade diversion offsetting impact of weak exports on country's GDP growth. She sees net positive impact boosting GDP growth by 10bp this year, putting it above the BNM's current forecast range of 4.3-4.8%. However, she is also mindful of prevailing uncertainty to that end. Malaysia is positioning itself as a key destination for manufacturers to relocate factories as the US-China trade tensions heat up.
- **Indonesia:** Re-elected President Jokowi called on other leaders in the ASEAN to step up efforts to maintain stability in the face of the protracted trade war and its detrimental impact on economic growth. Jokowi had previously pushed government officials to pursue pro-growth strategies and with the Bank Indonesia on deck, we do expect the central bank to at least lean dovish at its policy meeting but still keep rates unchanged to ensure

continued currency stability.

- **Philippines:** Bangko Sentral ng Pilipinas (BSP) reported the balance of payments surplus of \$5.2 bn in the month of May, likely from inflows related to the financial account as the current account remains in the red. The BSP is also on deck on Thursday with the consensus split on whether the BSP will cut rates. We think it will enact a dovish pause by keeping rates steady but hinting at a cut in the near term.

What to look out for: Central bank super Thursday

BoJ meeting (20 June)

- Bank Indonesia meeting (20 June)
- Taiwan central bank meeting (20 June)
- Bangko Sentral Pilipinas meeting (20 June)
- BoE meeting (20 June)

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What will happen after Xi-Trump meeting in G20

China and the US have scheduled a sideline meeting at the G20 in late June. What will happen next?



Source: Shutterstock

Donald Trump, Xi Jinping. President Donald Trump, right, with China's President Xi Jinping, left

China US meeting scheduled

Overnight, announcements from both China and the US have stated that the two Presidents will meet at the G20 summit in Osaka for "extended" meetings to discuss the ongoing trade conflict.

As we have claimed a few times in our notes, we do not believe that the meeting will deliver a trade deal, even if the meeting does take place. From the Chinese side, the discussion with US President Trump is expected only to exchange views on fundamental issues concerning the development of China-US relations.

What will happen after Xi and Trump meet?

Reading carefully from the statement from China, we only expect that both sides will repeat their views on the already drafted terms. But it is difficult to see any concrete progress that would either lead to a deal or improve the current deadlock situation.

During the meeting, President Trump will probably leverage on recent weak China economic data to persuade President Xi to agree that a trade deal is in China's interests. President Xi may use this opportunity to show President Trump that as long as both sides keep talking it will be helpful for the US economy and therefore President Trump's election campaign.

As such we expect no real change following the G20 sideline meeting. The fact that both sides are talking should at least postpone thoughts of a further increase in tariffs, for a while at least, until either side comes up with different thoughts.

Preventing any meaningful all-encompassing trade deal, there are still some fairly substantial hurdles. One is reform of state-owned enterprises, which is related to a lot of laws in China and fundamentally an issue of the Chinese political and economic model - in a word, sovereignty. Technology will also be discussed, and we expect China will confirm that there are no security issues on Chinese-made technological equipment. Though we do not think the US will accept this claim.

So the news on the talks in Osaka is a short term positive for asset markets, but we believe any talks will change little unless either side makes some meaningful concessions, which we do not view as likely at this time.

"As such we expect no real change following the G20 sideline meeting. The fact that both sides are talking should at least postpone thoughts of a further increase in tariffs, for a while at least, until either side comes up with different thoughts. "

Yuan has already reflected the good news

USD/CNY and USD/CNH have already appreciated from the range of around 6.93-6.934 at the end of the trading session on 18th June to around 6.90 level (as of writing) for both USD/CNY and USD/CNH.

Markets are reacting positively to the fact that at least both sides are willing to talk about trade, even if this is only likely to deliver a short-term boost.

The yuan appreciation matches our forecast of USD/CNY at 6.90 by the end of June 2019.

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BI and BSP to leave policies on hold

The central banks of Indonesia and the Philippines are expected to await more data and enact a dovish pause on Thursday.



Source: Shutterstock

Emerging market central banks to take their cue from the FOMC

Despite dovish comments from select FOMC members, the markets are not expecting the Fed to cut rates at the close of its 19 June meeting. Investors will be keenly awaiting the release of the Fed's latest economic projections and of the so-called "dot plots" for guidance.

A number of emerging market central banks will be meeting shortly after, including Bank Indonesia (BI) and the Bangko Sentral ng Pilipinas (BSP). Barring any surprise cut from the Fed, we do not expect fireworks from BI or BSP at their respective policy meetings tomorrow. However, we do expect both to enact a "dovish pause" by keeping the policy stance neutral but simultaneously signaling the increased likelihood for easing in the near term, depending on prevailing conditions.

Recipe for a dovish pause: dovish overtures but data-dependent

Dovish overtures

Governors of both the central banks have pointed to easing monetary policy. BI Governor Warjiyo has indicated that "there's room to lower interest rates", while BSP's Diokno has openly pledged to slash policy rates further, noting that this would be inevitable. It appears safe to say that both central banks are ready and willing to pull the trigger on further rate cuts - both having engaged in aggressive policy tightening in 2018 (with a total 175bp in rate hikes in the face of heightened risk-

off tone).

Data-dependent

Despite their dovish comments, both Diokno and Warjiyo have stuck to script by invoking data dependency in the timing of their much-anticipated monetary actions. Their respective economies currently have inflation running within policy targets, while their currencies have been relatively stable in 2019. Meanwhile, growth in the Philippines hit a snag in 1Q19 while re-elected President Jokowi of Indonesia has asked his cabinet to help spur growth via increased investments. But, given the external environment (Brexit, trade war, etc), we expect these two central banks to seek validation from data releases before they actually move on easing.

The x-factor: the current account

Part of the reason why BI and BSP were actively hiking policy rates in 2018 stemmed from concerns regarding their current account deficits. Both Indonesia and the Philippines continue to post sizeable current account gaps as of 1Q19 (Indonesia: 2.6% of GDP, Philippines: 1.5% of GDP). Given the prospects for slower global trade due to the protracted trade spat, we could see their current account deficits remain relatively wide in 2019.

Given this outlook, we can expect BI and BSP to tread cautiously on rate cuts but act decisively to ease monetary policy should the data indeed support a reduction in policy rates. We believe they will keep their powder dry on Thursday but, at the same time, leave the door wide open for easing.

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